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June 4, 2018

VIA ELECTRONIC FILING

Attention: Filing Center
Public Utility Commission of Oregon
P.O. Box 1088
Salem, Oregon 97308-1088

Re: Docket UG 344: NW Natural Request for a General Rate Revision

Attention Filing Center:

Attached for filing in the above-referenced docket is an electronic copy of NW Natural's Reply Testimony of Randolph S. Friedman (NW Natural//2400).

Please contact this office with any questions.

Sincerely,

Alisha Till

Alisha Till
Legal Assistant

Enclosure

BEFORE THE

PUBLIC UTILITY COMMISSION OF OREGON

UG 344

NW Natural

Reply Testimony of Randolph S. Friedman

ISS/OPTIMIZATION
EXHIBIT 2400

June 4, 2018

EXHIBIT 2400 – REPLY TESTIMONY – ISS/OPTIMIZATION

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NW NATURAL
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I. INTRODUCTION AND SUMMARY

Q. Please state your name, business address, and present occupation.

A. My name is Randolph S. Friedman and my business address is 220 NW Second Avenue, Portland, Oregon 97209. I am employed by NW Natural Gas Company (NW Natural or Company) as the Senior Director, Gas Supply.

Q. Are you the same Randolph S. Friedman that previously provided Direct Testimony in this docket?

A. Yes, I presented NW Natural/1300.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my Reply Testimony is to present NW Natural's response to opening testimony filed on May 4, 2018, by the Public Utility Commission of Oregon (Commission) Staff (Staff), the Citizens' Utility Board (CUB), and Alliance of Western Energy Consumers (AWEC) regarding the recommendations made by the Liberty Consulting Group's (Liberty) Final Report on NW Natural's optimization activities (the Liberty Report).

Q. How is your testimony organized?

A. I have organized my testimony to first provide an overview of the Company's proposal and then the Company's response to the arguments raised by Staff, CUB and AWEC.

II. The Liberty Report

Q. Please describe the basis for the Liberty Report and the information contained in the Liberty Report.

A. The Company's revenue sharing arrangements for storage services and optimization activities (described below) were investigated as part of its 2011 general rate case, Docket No. UG 221.[1] The Commission determined that this investigation was more appropriate for a separate proceeding and opened Docket No. UM 1654.[2] The result of Docket No. UM 1654 was a Commission Order (Order No. 15-066) directing the parties in such proceeding to form a steering committee to hire a third-party for purposes of conducting a study that would examine the risks, costs and benefits for NW Natural's optimization activities, the assets being utilized for these activities, the allocation between regulated and non-regulated services, and the components of the Company's system that drive the costs and revenues associated with interstate storage.[3]

Consistent with the Commission's Order, Liberty was retained and issued the Liberty Report which includes recommendations regarding the Company's revenue sharing arrangements for its storage services and optimization activities.[4]

As part of this proceeding, the parties were afforded an opportunity to provide testimony in response to the Liberty Report and the recommendations contained therein.

III. Interstate Storage Service

Q. Please explain the Company's Interstate and Intrastate Storage Services.

A. The Company's Mist Storage Services are provided to interstate and intrastate markets at negotiated market prices, subject to a FERC-mandated maximum rate

[1] NW Natural/1300, Friedman/30.

[2] *Id*.

[3] NW Natural/1300, Friedman/31 *citing In the Matter of Northwest Natural Gas Company, Investigation of Storage and Optimization Sharing*, Docket No. UM 1654, Order No. 15-066 at 5 (Mar. 5, 2015).

[4] NW Natural/1300, Friedman/31; *see also* NW Natural/1301.

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cap.[5] These services include injection, withdrawal, and underground storage of customer-owned gas at Mist, as well as the transportation of customer-owned gas to and from Mist Storage using NW Natural's high-pressure pipeline system.[6]

Q. What is the current sharing arrangement for intrastate and interstate storage services?

A. Pursuant to Schedule 185, NW Natural shares with eligible customers the net margin received from *non-utility* interstate and intrastate storage services on a 20/80 basis.[7][8]

Q. Please provide an overview of the Liberty Report recommendation regarding Interstate Storage.

A. As detailed in my initial testimony and in the Liberty Report, Liberty determined that the current sharing arrangement for the Company's non-utility interstate and intrastate storage services is consistent with industry standards and is balanced and appropriate.[9] Liberty found that no adjustments to the current sharing arrangement were necessary.[10]

Q. Please explain the positions of Staff and other parties regarding the Liberty Report recommendation.

A. Staff, CUB and AWEC each commented regarding the Liberty Report recommendation to maintain the current sharing arrangement for non-utility

[5] NW Natural/1300, Friedman/8.

[6] NW Natural/1300, Friedman/9-10.

[7] NW Natural/1300, Friedman/24.

[8] Schedule 185 also applies to optimization revenues related to customer-owned assets at Mist, which are shared on a 67/33 basis.

[9] NW Natural/1300, Friedman/32.

[10] NW Natural/1300, Freidman/32; *see also* NW Natural/1301, Friedman/35.

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interstate and intrastate storage services. Each of these parties agreed that, based on the Liberty Report, no changes in the cost sharing arrangement for these services are appropriate.[11]

Q. What is the Company's response to these positions?

A. The Company agrees with the recommendation of the Liberty Report, supported by Staff, CUB and AWEC, to maintain the status quo regarding the cost sharing arrangement for non-utility interstate and intrastate storage services. This position is consistent with my initial testimony.

IV. Optimization Activities

Q. Please describe the Company's optimization activities.

A. As set forth in greater detail in my initial testimony, the Company's optimization activities fall into five general categories: (1) Mist Storage optimization; (2) liquids extraction; (3) commodity contract (portfolio) optimization); (4) pipeline capacity optimization; and (5) off-system storage optimization.[12] The Company has engaged a third-party to manage these optimization activities through an asset management agreement (AMA).

Q. Please explain how the Company works with the third-party asset manager to perform the optimization activities?

A. The Company's Gas Supply Department is responsible for negotiating the terms of the AMA arrangement and developing strategies with the third-party optimization partner to maximize value while maintaining reliability standards for core utility and

[11] Staff/13000, Glosser/12; CUB/200, Jenks/14; AWEC/400, Finklea/4-5.

[12] NW Natural/1300, Friedman/13.

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storage service customers.[13] At least one individual in the Gas Supply Department is involved on a daily basis in consultation with the optimization partner to review current positions, assess available resources, and determine new opportunities for optimization.[14] The Company maintains this close working relationship with its optimization partner because this allows the Company to adapt as needed to changing market conditions and customer requirements.[15] This ability to adapt allows the Company (together with the optimization partner) to undertake long-term strategies that result in higher values for customers.[16]

Q. Do customers bear the costs of this utility involvement in the optimization process?

A. No. The costs for this utility involvement are allocated to the separate, non-utility gas storage business segment where the costs and revenues of the storage services and optimization activities are recorded.[17]

Q. Please explain how revenues associated with these optimization activities are shared with customers.

A. Revenue sharing for the Company's optimization activities are governed by Schedule 186, "Special Annual Core Pipeline Capacity Optimization Credit." This schedule applies to firm and interruptible sales service customers whose rates include costs related to upstream pipeline capacity.[18] Schedule 186 provides that

[13] NW Natural/1300, Friedman/13.

[14] NW Natural/1300, Friedman/13.

[15] NW Natural/1300, Friedman/13.

[16] NW Natural/1300, Friedman/13.

[17] NW Natural/1300, Friedman/14.

[18] NW Natural/1300, Friedman/25.

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NW Natural will share with eligible customers the net margin attributable to third-party optimization for the entire portfolio of upstream capacity contracts.[19] Under Schedule 186, net revenues are shared with the Company's firm and interruptible sales customers on a 67/33 basis (67 percent credited to customers and 33 percent retained by NW Natural).[20]

In addition, Schedule 185 applies to optimization revenues related to customer-owned assets at Mist (shared on a 67/33 basis) and non-customer owned assets at Mist (shared on a 20/80 basis).[21]

Q. Please explain the Liberty Report recommendation regarding these optimization activities.

A. Liberty did not make a specific recommendation regarding the revenue sharing associated with the Company's optimization activities. Instead, Liberty stated that there is room to reduce NW Natural's share of optimization margins, asserting that this reduction would bring the Company closer in line with sharing arrangements that exist in other jurisdictions.[22]

Q. Please explain how Liberty reached this conclusion regarding the Company's revenue sharing associated with its optimization activities.

A. Liberty determined that while the Company works diligently with its asset manager to promote the robust optimization of its portfolio assets and has produced substantial value for its customers, the efforts undertaken by NW Natural are not

[19] NW Natural/1300, Friedman/25.

[20] *Id*.

[21] NW Natural/1300, Friedman/24.

[22] NW Natural/1300, Friedman/32; *see also* NW Natural/1301, Friedman/65.

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beyond those generally seen in the industry.[23] Liberty also presented the results of a survey regarding the sharing arrangements for optimization activities generally found in the industry, which found that the percentage of revenue shared with NW Natural customers falls at the low end of the observed range for jurisdictions that provide for sharing.[24] Based on these determinations, Liberty concluded that there is room to reduce the Company's sharing percentage for these activities.[25]

Q. Please explain the positions of Staff and other parties regarding the Liberty Report recommendation for revenue sharing associated with optimization activities.

A. Staff, CUB and AWEC have each provided their own recommendation regarding the Company's revenue sharing associated with optimization activities, as follows.

Staff: Staff is recommending that a 90/10 split be adopted based on the conclusions in the Liberty Report that optimization is a core responsibility of prudent utility management and that the Company's oversight of asset optimization does not rise to a level beyond standard industry practice. Staff also points to Liberty's conclusions that the Company does not bear any unusual risk associated with the optimization activities and that the current sharing arrangement provides a lower allocation to customers than most jurisdictions considered by Liberty.[26] Staff does acknowledge that some percentage of net revenue should be retained

[23] NW Natural/1300, Friedman/32; *see also* NW Natural/1301, Friedman/65.

[24] NW Natural/1300, Friedman/32-33; *see also* NW Natural/1301, Friedman/52.

[25] NW Natural/1300, Friedman/33; *see also* NW Natural/1301, Friedman/65.

[26] Staff/300, Glosser/13.

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by NW Natural to provide the Company with an incentive to commit fully to asset optimization.[27]

<u>CUB</u>: CUB is also recommending that a 90/10 split be adopted in recognition of its assertion that asset optimization is a fundamental obligation of all utilities.[28] CUB argues that engaging in asset optimization is simply part of the Company's obligation to prudently operate its business. CUB is open to allowing some incentive to the Company to ensure that customer benefits are maximized but believes that a 90/10 split will provide this incentive.[29]

<u>AWEC</u>: AWEC is recommending that an 85/15 split be adopted for resources that are in customer rates based on AWEC's assertion that the Liberty Report has concluded that NW Natural's optimization activities do not create a "risky enterprise" for the Company and that these activities are not especially complex or out of line with normal utility practices.[30] AWEC argues that NW Natural's role is limited due to its retention of an experienced asset manager and that asset management has been standardized to a certain degree by FERC, further reducing the risks to the Company.[31] AWEC also argues that reducing the sharing allocation will not reduce the Company's incentive to maximize revenues; AWEC asserts that this conclusion is supported by the Liberty Report.[32]

[27] Staff/300, Glosser/15-16.

[28] CUB/200, Jenks/18.

[29] CUB/200, Jenks/18.

[30] AWEC/400, Finklea/5-6.

[31] AWEC/400, Finklea/6.

[32] AWEC/400, Finklea/7.

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AWEC also argues that the Commission should "flip" the 20/80 split for resources that are not in customer rates (*i.e.*, customers should receive eighty percent of the revenues associated with these revenues).[33] AWEC argues that this recommendation is supported by the Liberty Report.[34] AWEC does not specifically address this recommendation other than to say that its proposal provides a higher sharing percentage to the Company (than 85/15) because these resources (resources not in customer rates) rely less on customers' prior investment.[35]

Q. Does the Company agree with these conclusions regarding the allocation of revenues that result from optimization activities?

A. No. Contrary to the assertions of the parties, the Company believes that it has gone, and continues to go beyond the efforts typically expended by LDCs in the optimization of customer assets. The Company has actively engaged with its third-party asset manager to ensure that it achieves the best results (*i.e.*, value) for customers. As described above and in my initial testimony, this includes daily interactions with the asset manager to ensure that long-term plans are meeting their objectives and making changes to these plans when necessary. Our experience and information suggest that this level of involvement is unusual.

Moreover, over the past decade, NW Natural has attained very significant value for its utility customers flowing from these optimization activities. Specifically, customers have received a cumulative $133.5 million in credits since 2000.[36] This

[33] AWEC/400, Finklea/5.

[34] AWEC/400, Finklea/5.

[35] AWEC/400, Finklea/7.

[36] NW Natural/1300, Friedman/29.

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success is proof that the current sharing percentages adequately incent the Company to engage in the active management of the optimization program that is required achieve these benefits.[37] If NW Natural's sharing percentage is substantially eroded—as advocated by the parties—basic economics would suggest that the Company's incentive to achieve the consistently favorable results enjoyed under the current framework would also be substantially altered. NW Natural believes that the current arrangement has worked well, that it provides adequate and reasonable incentives, that it has produced tremendous value for customers, and that it should be retained.

Q. Does the Company have any other concerns with these recommendations to make significant adjustments to the revenue sharing allocation for optimization activities?

A. Yes. While the parties are correct that the Liberty Report states that there is room to reduce NW Natural's share of revenues, the Liberty Report falls short of providing detailed information regarding the results of the peer utility companies it has used as the comparison group. As a result, the Liberty Report provides an overview of the revenue sharing arrangements for NW Natural's peer utilities but does not go so far as to provide a comparison of the *results* of each arrangement. Therefore, it is entirely possible that while NW Natural's sharing may provide customers with a relatively smaller sharing percentage, NW Natural's customers may well be receiving significantly larger revenues. Given this lack of detailed information, the Commission should be hesitant to impose a significant change to the Company's current revenue sharing framework because it *is* certain that the

[37] NW Natural/1301, Friedman/45 (Confidential).

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Company has provided significant benefits to customers through its optimization activities.

The Company is also concerned that AWEC has provided absolutely no support for its recommendation to flip the split between customers and the Company with respect to resources not in customer rates.[38] The Liberty Report does not support this recommendation and AWEC has similarly provided no support in its testimony. Such a significant change is therefore unwarranted and should not be considered.

Q. Do the parties make any other recommendations regarding the revenue sharing allocation?

A. Yes. CUB also makes a recommendation regarding how the asset manager costs are allocated. CUB states that under the current allocation, the asset manager's share is allocated to the non-Mist optimization revenues.[39] CUB asserts that the result of this arrangement is that the asset manager costs come out of the revenues that are shared on a 67/33 basis, instead of the 20/80 basis.[40] As a result, CUB argues that NW Natural's income from optimization is increased inappropriately because the asset manager is optimizing both the Mist and non-Mist portion of activities.[41] CUB argues that it would be more appropriate for customers and shareholders to contribute based on their share of revenues.[42] In order to achieve this result, CUB recommends that asset management costs be

[38] AWEC/400, Finklea/5.

[39] CUB/200, Jenks/19.

[40] *Id*.

[41] *Id*.

[42] CUB/200, Jenks/20.

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allocated across all functions, before applying any sharing.[43] The net income (that results after paying the asset manager) is the income that would be subject to the revenue sharing allocation.[44]

Q. Does the Company agree with CUB's recommendation regarding payment of the asset manager costs?

A. CUB's comments relate to the method through which NW Natural determines the share of its revenues, net of its AMA partner's share, that are allocated between the various revenue sharing percentages. NW Natural has accounted for the costs shared with its AMA partner consistently, and in a way that it believes is straightforward and appropriate. NW Natural is, however, open to seeking to determine a method for allocating its AMA partner's expenses across the various revenue streams, in order to alleviate CUB's concerns.

V. Results of Operations Report

Q. Does the Company report its earnings related to optimization activities?

A. Yes. The Company currently reports its optimization revenues annually to the Commission, as part of a confidential report.

Q. Does the Liberty Report make any recommendation regarding the Company's reporting practice?

A. No. The Liberty Report is silent on this issue.

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[43] *Id*.

[44] *Id*.

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Q. Please explain CUB's recommendation regarding reporting of the Company's optimization activities earnings.

A. CUB recommends that the Company be required to include all optimization revenues associated with rate-based, regulated activities in its Results of Operations Report (ROO) but to exclude optimization revenues associated with interstate storage.[45] Importantly, CUB is not arguing that optimization revenues be included in earnings tests associated with deferrals, or other mechanisms where earnings are examined, but rather that these revenues be included in the ROO for informational purposes.

Q. Why does CUB believe that optimization revenues should be included in the ROO?

A. CUB argues that the currently-used format for the ROO (*i.e.*, the version routinely filed by the Company) does not allow a reader to determine all of the earnings from NW Natural's regulated system.[46] CUB argues that this makes the ROO less accurate and transparent.[47] CUB argues that providing this additional information would be particularly helpful if Oregon transitions to incentive regulation because incentive regulation will require the Commission to evaluate the effectiveness of such regulation and evaluation of the revenues earned by the Company related to optimization activities revenue will be part of this analysis.[48]

[45] CUB/200, Jenks/25.

[46] CUB/200, Jenks/21.

[47] CUB/200, Jenks/21.

[48] CUB/200, Jenks/22.

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Q. Does the Company agree that the best way to achieve this level of transparency is by including the revenues associated with the Company's optimization activities in the ROO?

A. No. As an initial matter, CUB's recommendation is premature because it appears to be largely supported by an argument that the information would be needed to evaluate the impacts of incentive regulation. However, Oregon has not yet adopted incentive regulation. Moreover, CUB is correct in observing that NW Natural is reluctant to include optimization revenues in the ROO, because doing so would incorrectly imply that these revenues should be considered in the application of earnings reviews[49]—aside from the Company's Site Remediation and Recovery Mechanism (SRRM), where 50 percent of optimization revenues are already included, as ordered by the Commission in Order No. 15-049.[50]

Nevertheless, the Company does agree with CUB that transparency is important and is not averse to providing this additional data for informational purposes in the Company's annual Optimization Report. To this end, NW Natural would agree that, in addition to providing information about revenues, the Company could provide the impact on its earnings of its own sharing portion. Providing this information outside of the ROO would achieve CUB's goal of transparency while eliminating any suggestion that this revenue should be considered as part of the Company's earnings for other purposes.

[49] CUB/200, Jenks/23.

[50] *In the Matter of NW Natural Gas Company dba NW Natural, Mechanism for Recovery of Environmental Remediation Costs*, Docket No. UM 1635, Order No. 15 049 at 27 (Feb. 20, 2015).

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Q. What does AWEC argue regarding reporting of the Company's revenues derived from optimization activities?

A. AWEC agrees with CUB that the Company should report its optimization activities revenue in the ROO.[51]

Q. What rationale is offered by AWEC in support of this recommendation?

A. AWEC refers to arguments made in Docket No. UM 1654 and states that the income should be included in the ROO because it is derived or made possible from customer-funded assets.[52]

Q. Does the Company agree with AWEC's recommendation?

A. No. As stated above, the Company is not averse to including these revenues for informational and transparency purposes as part of its Optimization Report. However, the Commission has already determined (in Docket No. UM 1654) that half of these revenues should be included in the Company's earnings sharing test and only for purposes of its SRRM.[53] AWEC has not set forth any new arguments that would support deviating from this practice and therefore, the Company's proposal to include this information as part of its Optimization Report should be adopted.

VI. Conclusion

Q. Does this conclude your testimony?

A. Yes, it does.

[51] AWEC/400, Finklea/8.

[52] AWEC/400, Finklea/8.

[53] *In the Matter of NW Natural Gas Company dba NW Natural, Mechanism for Recovery of Environmental Remediation Costs*, Docket No. UM 1635, Order No. 15 049 at 27 (Feb. 20, 2015).

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